Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted] :TL-N-1018-98
[redacted]

date: November 30, 1999

to: [redacted], Appeals Officer
[redacted], CEP Case Manager

from: District Counsel, [redacted]

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subject: **Two of the Issues in the [redacted] Audit:**
(1) Deduction of Penalty under Subsection 162(f); and
(2) Inclusion of Advance Payment as Income.

DISCLOSURE STATEMENT

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ISSUES

(1) Under subsection 162(f) of the Code, should the Service disallow the deduction by [redacted] of a $[redacted] penalty (the Penalty), which amount was based on "the economic benefit (if any) resulting from" violations of the Clean Water Act, 33 U.S.C. § 1319(d)?

(2) Should have recognized the $ payment (Advance Payment) as income upon its receipt in or should have recognized $ of the Advance Payment in each of the next four years in which bought the minimum amount of ?

CONCLUSIONS

(1) The Service properly disallowed s deduction of the Penalty.

(2) should have recognized all $ of the Advance Payment as income when received the Advance Payment in .

FACTS

(1) The Penalty

In , two public interest groups sued through its subsidiary . In the First Amended Complaint, the plaintiffs alleged that discharged pollutants through its wastewater treatment plant and that the pollutants ended up in the . First Amended Complaint, p. 8, ¶ 22. They alleged violations of sections 301 and 307 of the Clean Water Act, 33 U.S.C. §§ 1311 and 1317. Id. at p. 1, ¶ 1. They requested that be ordered to comply with applicable pretreatment standards. Id. at p. 10, ¶¶ 2-4. They also requested that be ordered to pay "civil penalties up to $ per day for each violation of the Clean Water Act occurring from to the present," under 33 U.S.C. § 1319(d). Id. at pp. 10-11, ¶ 5. Finally, they requested an award of fees and costs under 33 U.S.C. § 1365(d). Id. at p. 11, ¶ 6. The Environmental Protection Agency intervened, alleging similar violations. Consent Decree, p. 2.

In , the parties signed a Consent Decree, which stated:

> WHEREAS, the parties have negotiated in good faith the civil penalty in paragraph 33, such amount being based in large part upon the alleged economic benefit enjoyed by Defendant as a result of the acts complained of by Plaintiffs;
>
> * * * * * * *
>
> 33. . . . Defendant shall pay a civil penalty in the amount of $ plus interest to the United States. Consent Decree, pp. 2, 25.

[redacted] also agreed to comply with a program for treating its discharge and to pay $[redacted] in fees and costs to the public interest groups. Id. at pp. 7-25, ¶¶ 8-32, p. 32, ¶ 46.

On its [redacted] return, [redacted] deducted the $[redacted] that it had accrued as the expected amount of the Penalty, as well as $[redacted] in expected litigation costs. [redacted] disclosed that the remaining accrued amount, $[redacted], was not deductible under subsection 162(f).

In an internal [redacted] memorandum dated [redacted] [redacted] told [redacted], "[o]f this [$[redacted] amount, $[redacted] was attributed to the 'gravity component' by the Government. Therefore, the economic benefit portion of this payment equals $[redacted]." Similarly, a disclosure statement faxed from [redacted] on [redacted], stated:

> 1) During [redacted], [redacted] [which is the successor to [redacted] agreed to U.S. Civil Penalties for violation of the Clean Water Act 33 USC Sec. 1251 in the amount of $[redacted] and recorded on its [redacted] books that amount of expense. The penalty that was negotiated between the parties was composed of an Economic Benefit component of $[redacted] and a Gravity component of $[redacted]. The Economic Benefit component was deducted on the [redacted] Form 1120. The Gravity component of $[redacted] was not deducted as it is nondeductible under IRC 162(f).

([redacted]'s reference to the "Gravity component" refers to the "extent and gravity of the violation." 33 U.S.C. § 1319(g)(3).)

In [redacted], [redacted] paid the Penalty.

The Service disallowed the $[redacted] deduction, asserting that none of the Penalty was deductible under subsection 162(f). [redacted] responded that it "would be willing to agree that the $[redacted] economic benefit portion of the penalty should be deductible in [redacted] when it was paid rather than in [redacted] when it was accrued." Protest, p. 37.

(2) The Advance Payment

As a result of its litigation with the Environmental Protection Agency, [redacted] built a wastewater treatment plant. While the plant was being built, [redacted] discontinued its own production of a pigment called [redacted] and needed another source of [redacted].

On , and entered a License Agreement and a Qualification and Testing Agreement. Under Article 2 of the Licence Agreement, granted a "non-exclusive" license to use 's technology concerning , effective only upon execution of a Supply Agreement. Under Article 3, agreed to pay $ for the license (the License Fee). The agreement provided no term for the licence.

Under paragraph 1.c of the Qualification and Testing Agreement, the parties agreed that if produced of sufficiency quality, they would enter into the Supply Agreement. Under paragraph 2.a, agreed to pay $ (the Advance Payment) as a "prepaid volume discount."

On , and entered the Supply Agreement. Under paragraph 1.a, agreed to buy its "purchase requirements" of which it estimated to be per year. (We are simplifying the computation, which actually concerned various forms of .) Under paragraph 1.b, promised to buy of in each of the following years, through . Under paragraphs 2.a.ii and 11.a, agreed to refund of the $ Advance Payment for any year in which did not buy of unless 's failure to purchase this minimum amount was due to causes beyond 's reasonable control. Under paragraph 2.b, any purchases by from third parties during a period when was excused from performing due to forces beyond 's reasonable control would be counted toward the minimum.

None of the agreements addressed any interest earned on the Advance Payment. There were no restrictions on 's use of the Advance Payment. provided no security for its repayment. Examination stated that the Advance Payment was "deposited into 's account. had full use of the funds without any restrictions, nor did the above agreements set forth any restrictions on the use of the monies received." did not dispute this statement.

In , recognized the $ License Fee as income. In each of the years, through bought at least the minimum amount of and recognized $ of the Advance Payment as income.

Since then, has constructed its wastewater treatment plant and resumed its own production of .

Examination concluded that [redacted] should have recognized both the $[redacted] Advance Payment and the $[redacted] License Fee in [redacted] and that the two payments are inseparable. [redacted] responded that the Advance Payment and the License Fee are separable because they were negotiated in good faith and subject to separate agreements.

ANALYSIS

(1) The Service properly disallowed [redacted]'s deduction of the Penalty.

Subsection 162(f) prohibits the deduction of "any fine or similar penalty paid to a Government for the violation of any law." A "fine or similar penalty" includes an amount "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)." Treas. Reg. § 1.162-21(b)(1)(ii). However, "[c]ompensatory damages . . . paid to a government do not constitute a fine or penalty." Treas. Reg. § 1.162-21(b)(2).

[redacted] paid the Penalty in settlement of its potential liability under section 309 of the Clean Water Act, which provides the following factors for calculating civil penalties:

> **(d) Civil penalties.** Any person who violates section 301 . . . [or] 307 . . . of this Act . . . shall be subject to a civil penalty not to exceed $25,000 per day for each violation. In determining the amount of a civil penalty the court shall consider the seriousness of the violation or violations, the economic benefit (if any) resulting from the violation, any history of such violations, any good-faith efforts to comply with the applicable requirements, the economic impact of the penalty on the violator, and such other matters as justice may require. 33 U.S.C. § 1319(d).

We have no facts to dispute [redacted]'s assertion that $[redacted] of the Penalty was based on "the economic benefit (if any) resulting from the violation." This assertion is consistent with the page 2 of the Consent Decree, which stated that the total amount of the Penalty, $[redacted] was "being based in large part upon the alleged economic benefit enjoyed by Defendant as a result of the acts complained of by Plaintiffs." It is also consistent with [redacted]'s statement in its internal memorandum that, "[o]f this [$[redacted] amount, $[redacted] was attributed to the 'gravity component' by the Government. Therefore, the economic benefit portion of this payment equals $[redacted]."

In a similar case, the Claims Court held that a penalty, which was largely based on the economic benefit enjoyed by a violator of the Clean Water Act, was punitive and not deductible. Colt Indus., Inc. v. United States, 11 Cl. Ct. 140, 147 (1986), aff'd, 880 F.2d 1311 (Fed. Cir. 1989). In Colt, a subsidiary corporation, Crucible, Inc., manufactured steel products in Pennsylvania. The Environmental Protection Agency recommended seeking penalties under section 309 of the Clean Water Act. 11 Cl. Ct. at 140-41; 33 U.S.C. § 1319(d). ([redacted]'s Penalty was also based on that statute.) The Environmental Protection Agency also recommended seeking penalties under the Clean Air Act, which provides similar factors for calculating civil penalties:

> **(e) Penalty assessment criteria.** (1) In determining the amount of any penalty to be assessed under this section . . ., the Administrator or the court, as appropriate, shall take into consideration (in addition to such other factors as justice may require) the size of the business, the economic impact of the penalty on the business, the violator's full compliance history and good faith efforts to comply, the duration of the violation . . ., payment by the violator of penalties previously assessed for the same violation, the economic benefit of noncompliance, and the seriousness of the violation. 42 U.S.C. § 7413.

The Environmental Protection Agency calculated Crucible's potential penalty by allocating $4,860,000 to Crucible's economic benefit, $577,000 to the environmental harm, and $150,000 to Crucible's recalcitrance. Id. at 142. Discounting the total amount of the potential penalty based on litigation hazards, the parties agreed to a $1,600,000 penalty. Id.

The Claims Court held that the $1,600,000 penalty was punitive and not deductible under subsection 162(f). Id. at 147. Examining the legislative history of the Clean Air Act, it concluded that the punitive purpose of the penalties outweighed the compensatory purpose. Id. at 144-45. It stated that "[t]he legislative history of the Clean Water Act does not provide significant insight into the question regarding the punitive nature of section 309(d) of the Act, 33 U.S.C. § 1319(d)." Id. at 144. Because the legislative history referred to the Clean Air Act penalty provisions, the court incorporated by reference the punitive objective. Id. at 144-45.

The Claims Court's reasoning in Colt has not been weighed by other courts. However, commentators agree that Colt was correctly decided by the Claims Court. One commentator has concluded that "[t]he Claims Court decision [in Colt] was correct in its methodology and result." Edwin G. Torres, Note, Deductions of Civil Penalties Under Section 162(f): *Colt Industries, Inc. v.*

United States, 43 Tax Lawyer 823, 834 (1990). Another commentator suggests that the decision was correctly decided but wrongly reasoned: "While the asserted legislative intent did not support denial of deductions in five of seven cases, examination of the nature of the remedy supports the decisions. In none of those cases was the measure of the remedy loss to either the government or the victim." F. Philip Manns, Jr., Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?, 13 Va. Tax Rev. 271, LEXIS, at 116 (Fall 1993).

The Regulations conclude that a penalty imposed under another section of the Clean Water Act was not deductible. Treas. Reg. § 1.162-21(c), Ex. (2); 33 U.S.C. 1321(b)(6). That penalty was based on similar factors:

> (8) Determination of amount. In determining the amount of a civil penalty under paragraphs (6) or (7), the Administrator, Secretary, or the court, as the case may be, shall consider the seriousness of the violation or violations, the economic benefit to the violator, if any, resulting from the violation, the degree of culpability involved, any other penalty for the same incident, any history of prior violations, the nature, extent, and degree of success of any efforts of the violator to minimize or mitigate the effects of the discharge, the economic impact of the penalty on the violator, and any other matters as justice may require. 33 U.S.C. 1321(b)(8).

Based on Colt and on this example in the Regulations, we conclude that [redacted]'s Penalty is punitive and not deductible under subsection 162(f). In particular, we apply the Claims Court's reasoning:

> Plaintiff argues that the economic benefit factor in essence is restitution for damage to Pennsylvania's air and water. Plaintiff does not explain how removal of its economic benefit is a restitution for injury caused by pollution. 11 Ct. Cl. at 145.

The Penalty, which was based on [redacted]'s economic benefit from its pollution, is not restitution for the injury caused by its pollution.

Nonetheless, because this issue remains unaddressed by other courts, there are litigation hazards. We assume that [redacted] would choose to litigate this issue in Tax Court or in District Court and to avoid the Claims Court which decided Colt. Any decision by the Tax Court or the District Court would be appealable to the Ninth Circuit Court of Appeals. While the Ninth Circuit may give some weight to the Claims Court's reasoning, the Ninth Circuit would not

be bound by it. In addition, the Ninth Circuit may be distracted by the highly unusual reasoning of Federal Circuit Court in the appeal of Colt. The Federal Circuit Court concluded that it is the "office" of the Commissioner, not the courts, to determine whether the purpose of a civil penalty is compensatory or punitive. 880 F.2d at 1314. The Ninth Circuit would undoubtedly disagree with that conclusion. Talley Indus., Inc. v. Commissioner, 116 F.3d 382, 385-86 (9th Cir. 1997), rev'g and remanding T.C. Memo. 1994-608, on remand, T.C. Memo. 1999-200.

[redacted] may attempt to distinguish the facts in Colt. In their pleadings, the plaintiffs stressed that their purpose in seeking the penalties and an injunction was to encourage compliance with the Clean Water Act: "Without the imposition of appropriate civil penalties and the issuance of an injunction, there is a reasonable likelihood that Defendant will continue to violate the Clean Water Act to the detriment of Plaintiffs, their members, and the public generally." First Amended Complaint, p. 9, ¶ 25. The Tax Court has stated that subsection 162(f) does not prohibit the deduction of a penalty imposed for the purpose of encouraging compliance:

> If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it 'similar' to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not 'similar' to a fine within the meaning of section 162(f). Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 652 (1980).

Such an attempted distinction would not be meaningful. As stated by the Claims Court in Colt, every penalty encourages compliance:

> Every civil penalty has a remedial aspect, in the sense that it is to deter violations and encourage compliance with the law. If a remedial purpose were enough to take a civil penalty payment out of the ambit of section 162(f), then virtually no civil penalty would be subject to section 162(f) . . . . 11 Cl. Ct. at 146.

We distinguish the authorities cited by [redacted] [redacted] analogizes to the penalty imposed on a nonconforming vehicle under the Clean Air Act. Rev. Rul. 88-46, 1988-1 C.B. 76. Under section 205 of the Clean Air Act, a person who sells a vehicle that is not covered by a certificate of conformity must pay a civil penalty. The amount of the penalty is based on the amount a conforming

manufacturer would spend to meet the emission standard. 42 U.S.C. § 7524; 40 C.F.R. § 86.1113-87. The Service concluded that the penalty "is primarily designed as a permissive and equalizing formula to eliminate the competitive economic advantage that a nonconforming producer might otherwise have over a conforming producer." In other words, payment of the penalty is merely a charge for nonconformity. Thus, the penalty was not punitive and was deductible.

In distinction, [redacted]'s Penalty is not in the nature of a toll charge or fee for polluting. [redacted] cites no similar statutory provision indicating that the Penalty, which was imposed under 33 U.S.C. § 1319(d), was merely a charge for [redacted]'s "nonconformity."

[redacted] also analogizes to S&B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980). In S&B Restaurant, the taxpayer agreed to make monthly payments under Pennsylvania's Clean Streams Law until the town's sewer system was constructed and the taxpayer was connected to that system. Id. at 1229. The Tax Court held that the purpose of the payments was to permit the taxpayer to continue to discharge sewage, not to punish the taxpayer. The Court cited four factors:

> First, the petitioner was obligated to connect into the municipal sewer system when it became available and the payments were to continue only until such time. The indefiniteness of the total amount of the payments makes them distinguishable in some degree from a fine or penalty which is usually in a fixed amount. Second, the amount of the payment was fixed upon the basis of what the representative of the Commonwealth of Pennsylvania (Kates) believed would have been the charges petitioner would have had to pay if the municipal facility had been available. Third, the State would have attempted to block any attempt by petitioner to construct its own sewage treatment facilities. Fourth, Kates was given to understand that no practical environmental harm would be cause by petitioner's continued discharge of sewage waste. Id. at 1232-33 (footnote omitted).

None of these four factors apply to [redacted]'s Consent Decree. First, the amount of the Penalty was fixed. Second, the amount of the Penalty was based on "the alleged economic benefit enjoyed by Defendant as a result of the acts complained of by Plaintiffs." Third, no governmental entity blocked [redacted]'s compliance with the Clean Water Act. Nor did the Consent Decree permit [redacted] to continue its proscribed conduct. On the contrary, [redacted] agreed to an extensive compliance program. With respect to the fourth factor, the existence of environmental harm, the parties disagreed.

[redacted] asserts that "[s]imilar to the taxpayer in S&B Restaurants, supra, [redacted] [which is the successor to [redacted] contended that because its alleged nonconformity presented no problems for the treatment processes of any public water works system, no measurable environmental harm occurred as a result of its wastewater discharges." Protest, at ¶ 33. However, the Consent Decree does not state that the violations of the Clean Water Act resulted in no environmental harm. Indeed, the plaintiffs repeatedly alleged that the violations adversely affected public health. E.g., First Amended Complaint, pp. 5-6, ¶¶ 15, 16. Because the Consent Decree "is silent on the subject of the characterization of the settlement payment. . . . petitioner 'suffers the consequence' if evidence to establish entitlement to the disputed deduction is lacking." Talley Indus., Inc., T.C. Memo. 1999-200 (citing Talley Indus., Inc., 116 F.3d at 387-88).

Finally, [redacted] analogizes to Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043 (6th Cir. 1983). In Mason and Dixon, the taxpayer was charged with a misdemeanor under Virginia law and fined for operating overweight trucks. Id. at 1044; Va. Code Ann. § 46.1-16 (Michie 1974). The taxpayer was required to pay "liquidated damages," based on the amount of excess weight. 708 F.2d at 1044. The court held that the liquidated damages were not penalties under subsection 162(f). Id. at 1048.

We could quibble with some of the reasoning in Mason and Dixon. The court reasoned that the actual use of the liquidated damages for the construction and maintenance of highways showed that the damages were compensatory. Id. at 1047. While the actual use of [redacted]'s Penalty under the Clean Water Act is unclear, it is hard to imagine a "punitive use." However, we agree with the court's conclusion. Although not expressly considered by the court, one of the elements of liquidated damages in general is that "the amount is reasonable in light of the anticipated or actual harm caused by the breach." U.C.C. § 2-718(1). In other words, the term "liquidated damages" implies that the amount of the liquidated damages approximates the amount of the actual damages. In distinction, damages under the Clean Water, 33 U.S.C. §§ 1319(d), are not called "liquidated damages."

(2) [redacted] should have recognized all $[redacted] of the Advance Payment as income when [redacted] received the Advance Payment in [redacted]

Under the general rule for all taxpayers, gross income includes all income from whatever source derived. I.R.C. § 61(a). In addition, amounts received under a claim of right, without restriction as to their disposition, are taxable when received, even though the taxpayer may have a contingent obligation to restore the funds at some future point. North Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932).

In North American Oil, the Supreme Court required the taxpayer to include in gross income for 1917 the amount received as a result of a favorable judgment, although litigation over the taxpayer's right to the income continued until 1922:

> If a taxpayer receives earnings under a claim of right and without restriction as to disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. 286 U.S. at 424.

As more recently stated by the Tax Court, "it is well settled that amounts received under a claim of right, without restriction as to their disposition, are taxable when received, notwithstanding that the taxpayer may be under a contingent obligation to restore the funds at some future point." Professional Ins. Agents of Michigan v. Commissioner, 78 T.C. 246, 279 (1982), aff'd, 726 F.2d 1097 (6th Cir. 1984).

Under the general rule for accrual method taxpayers, income is included in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. § 1.451-1(a). All the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. Rev. Rul. 74-607, 1974-2 C.B. 149. Moreover, an advance payment of income is included in gross income in the year the advance payment is received because deferral would not clearly reflect income. Schlude v. Commissioner, 372 U.S. 128, 137 (1963).

Under these general rules, [redacted] should have included the $[redacted] Advance Payment in gross income when [redacted] received it in [redacted] received the Advance Payment under a claim of right, without restriction as to its disposition. Deferring inclusion of that amount for up to four years would not clearly reflect [redacted]'s income.

We consider two exceptions to these general rules: trade discounts and deposits.

Trade Discounts

[redacted] argued that these general rules do not apply because the Advance Payment was a "potential volume discount or a reduction in future cost of goods sold." Protest, p. 94. However, [redacted] cited no case in which a trade discount was paid in a year prior to the year of the purchase. [redacted] paid the Advance Payment from [redacted] to [redacted] years before [redacted] purchased the [redacted].

In trade discount cases, either: (1) at the time the goods were purchased, the seller accepted from the buyer a sum less than the billed amount as payment in full at the time the goods were purchased; or (2) the buyer paid the seller the full amount billed, but thereafter the seller remitted to the buyer a portion of the buyer's payment. E.g., Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 1980), acq. 1982-2 C.B. 1; Haas Brothers, Inc. v. Commissioner, 73 T.C. 1217 (1980), acq. 1982-2 C.B. 1; Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), acq. 1982-2 C.B. 2; John Graf Co. v. Commissioner, 39 B.T.A. 379 (1939).

Courts would be quite reluctant to permit a taxpayer to defer the inclusion of a payment as a trade discount beyond the year of its receipt. As stated by the Supreme Court, tax is assessed "on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt." Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363 (1931). The Court explained:

> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be gain or a loss. Id. at 364.

Within the next year, we may have the first court decision addressing suppliers payments' made in years prior to the taxpayers' purchase of the goods. TAM 9719005 (January 10, 1997). This summer, such a case was docketed for trial before the Tax Court. The common thread in all of the suppliers' agreements was that the grocery stores agreed that each supplier would be its sole source for those goods. In exchange, the suppliers paid the

grocery stores "discounts," "unearned advance allowances," "placement allowances," "incentive payments," and "advances." Some of the suppliers required the grocery stores to do more, such as maintain a minimum amount of shelf space for those goods or promote those goods.

Our position in that case is that the advance payments should be taken into account as income in the year of receipt. Those sole-supplier arrangements, for which payments were made on execution of the agreements rather than periodically as the grocery stores bought the goods, undermine the conclusion that the payments are exclusively for trade discounts.

In its [redacted] letter, [redacted] attempted to distinguish TAM 9719005 by asserting that [redacted] was not the sole supplier. We disagree. Under paragraph 1.a of the Supply Agreement, [redacted] agreed to buy from [redacted] its "purchase requirements" of [redacted] which [redacted] estimated to be [redacted] per year. Thus, under California's Uniform Commercial Code, [redacted] was obligated to buy its good faith requirements not unreasonably disproportionate to the estimated amount:

> § 2306. **Output, Requirements and Exclusive Dealings.** (1) A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded. Cal. Com. Code § 2306 (West 1964).

We recognize that the Supply Agreement is not a model of clarity. Under paragraph 1.a of the Supply Agreement, [redacted] estimated its requirements to be [redacted] of [redacted] per year. Under paragraph 1.b, [redacted] agreed to purchase a minimum of [redacted] per year. If [redacted] could buy [redacted] in excess of [redacted] per year from a third party, then [redacted] s estimate of its requirements to be [redacted] of [redacted] per year was a superfluity. However, this ambiguity does not change our conclusion that [redacted] was obliged to buy its "requirements" of [redacted] from [redacted]

Nor does the nonexclusive nature of the license change our conclusion. Licence Agreement, Art. 2. That [redacted] could sell the technology to others is not necessarily inconsistent with its obligation to buy its requirements of [redacted] from [redacted]. For example, the parties anticipated that [redacted] might buy [redacted] from "third parties" when [redacted] was excused from performing due to forces beyond its control. Supply Agreement, ¶ 2.b.

[redacted] also attempted to distinguish TAM 9719005 because [redacted] was not obliged to do more, such as maintain a minimum amount of shelf space for the [redacted] or promote the sale of [redacted]. We reject this distinction. First, not all of the grocery stores were obligated to do more. TAM 9719005, n.3. As summarized by the Service, "[a]t the heart of the dispute is the federal income tax consequences of these lump-sum cash payments and the contractual clauses granting the various vendors the status of exclusive or primary supplier." Second, we do not know whether [redacted] was obligated to do more. [redacted] provided no substantiation for its allocation of $[redacted] as the License Fee and $[redacted] as the Advance Payment. Thus, we cannot tell what portion of the $[redacted] [redacted] paid for the sole-provider status and what portion [redacted] paid for the licence.

[redacted] compared the Advance Payment to an inducement to purchase. Freedom Newspapers v. Commissioner, T.C. Memo. 1977-429 (1977). In 1969, the taxpayer bought the Jackson County Floridan and three other Florida newspapers. To induce the taxpayer's purchase of the Floridan, a broker had paid $100,000 into escrow and promised that this amount would be paid to the taxpayer if the broker could not sell the Floridan for its cost within a year. In 1971, after the broker had been unable to sell the Floridan, the taxpayer received the $100,000. The Court held that the $100,000 was not income to the taxpayer in 1971. Instead, the $100,000 was a reduction to the taxpayer's basis in the Floridan.

Freedom Newspapers does not support [redacted]'s position that an inducement or discount paid before a purchase is not income on payment. In Freedom Newspapers, the inducement was paid two years *after* the purchase, not *before* the purchase.

Deposits

An argument that [redacted] may raise is the Advance Payment was not gross income when received because it was a deposit. Although [redacted] has not yet articulated this argument, [redacted] characterized the Advance Payment on its books as a deposit.

Generally, if the payor controls the conditions under which a deposit will be repaid, the payment is not income to the recipient. Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 210 (1990). On the other hand, the payment is income to the recipient if the recipient "has some guarantee that he will be allowed to keep the money" and thus has "complete dominion" over the money. Id.

For example, in Indianapolis Power & Light, the utility required some of its customers to pay deposits. 493 U.S. at 204. However, each customer controlled the timing and the method of the refund of his deposit. Id. at 211. The Court held that the deposits were not income on receipt because the utility did not have complete dominion over the deposits. Id.

The Advance Payment was not a deposit because [redacted] had complete dominion over it. [redacted]'s obligation to refund the Advance Payment was contingent on whether [redacted] purchased the minimum amount of [redacted]. [redacted], not [redacted], controlled whether [redacted] purchased that minimum amount.

[redacted]'s Advance Payment is similar to the $6,700,000 payment that the Los Angeles Raiders received from the Los Angeles Memorial Coliseum Commission. Milenbach v. Commissioner, 106 T.C. 184 (1996). In Milenbach, the Raiders had to repay the $6,700,000 payment from revenues received from the operation of luxury suites to be constructed by the Raiders at the Coliseum. Id. at 187. Because the construction of the suites was within the sole control of the Raiders and there was no default or alternative payment provision, the Court found that the Raiders had the ability to control the repayment. Id. at 197. Therefore, the Court held that payment was income on receipt. Id.

In sum, we may debate which doctrine dictates our conclusion: did [redacted] have a claim of right to, or complete dominion over, the Advance Payment? However, the conclusion is not debatable. The Advance Payment was not a trade discount under Pittsburgh Milk Co., 26 T.C. at 717, and it was income on receipt.

In accordance with CCDM(35)3(19)4, we are furnishing a copy of this advisory opinion applying well-settled principles of law to the Assistant Chief Counsel (Field Service) for 10-day post-issuance review. Please call me at [redacted] ext. [redacted] if you have any questions.

[redacted]
District Counsel

By: _____
[redacted]
Attorney